C. The Threat of Predatory Pricing Underscores the Need for a Sound Approach to the Issue of Unreasonable Discrimination.

The existence of the current ILEC price cap structure in no way mitigates the ILEC incentives to unreasonably price discriminate. USTA and most of the ILECs in their initial comments repeat their mantra that predatory pricing under price cap regulation cannot succeed. According to the simple picture they try to paint, predation only involves driving an existing competitor out of business by means of below-cost pricing, and then earning supracompetitive profits by raising rates above costs (see, e.g., Statement of Schmalensee and Taylor attached to USTA Comments at 12; Bell Atlantic Comments at 20-21).[9]

After creating this "strawman" theory of predatory pricing, USTA and the ILECs knock it down with two arguments. First, because of the relatively high embedded costs of competitive entry and its associated low operating expenses, the assets of a bankrupt competitor would still remain in service, and thereby preclude supracompetitive pricing. Second, the presence of price cap regulation will assertedly prevent the ILECs from ever

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[9] Like Nelson at Copenhagen, the ILECs simply place a telescope to their blind eye, and announce they see no danger of predation other than the classic incumbent's reduction of prices in response to new competition in hope of destroying the entrant. See the Reply Statement of J. Hausman in support of BellSouth, which rails against ALTS for failing "to understand the basic economics of entry into telecommunications" (Statement at 1). But Professor Hausman never discusses any of the extensive literature concerning predation which extends to strategies beyond simple price responses, even though portions were cited in ALTS' initial comments and in the Second Further NPRM itself.

recovering supracompetitive prices. For the reasons shown below, the Commission should be quick to dispense with such economic fairy tales.

1. Existing or Future Price Cap Regulation Will Not Preclude Predatory Pricing.

Concerning the ILECs' claim that price cap regulation prevents predatory pricing, the economists relied upon by USTA and the ILECs make it clear in their testimony that the ILECs' asserted inability to recover supracompetitive prices is only true in a pure price cap situation, or where competition faces low entry barriers.[10] See, e.g., Schmalensee and Taylor (appended to USTA's comments, at 14): "To the extent that non-competitive services are isolated from competitive services under the price cap, lowering competitive service prices bestows no additional ability to raise non-competitive service prices to offset losses. Under price caps -- or any form of incentive regulation that breaks the link between observed costs and prices -- the LEC has the same disincentive to cross-subsidize as a competitive firm" (emphasis supplied).

But the Second Further NPRM would not require the ILECs to place the wire centers subject to potential competition in separate baskets from the wire centers which are not subject to potential competition. Consequently, the Schmalensee-Taylor

[10] See, e.g., the affidavit of Alfred E. Kahn submitted in the first round of comments endorsing the superiority of "pure" price caps.

defense concerns a price cap regime which is not being proposed by the Second Further NPRM. Furthermore, USTA and the ILECs have vehemently protested the continued "link" to earnings under current price cap regulation -- the very "link" which Schmalensee and Taylor insist must be broken if the ILECs' predatory incentive is to resemble that of a "competitive firm."

Finally, the proposal that rates which have been reduced below an SBI would not be allowed subsequent rate increases provides no necessary predatory protection whatever. As noted above, under a price cap system which still has links to earnings, or fails to separate wire centers into "non-competitive" and "subject to competition" baskets, an ILEC need not subsequently increase a decreased rate in order to achieve recoupment. Indeed, even under a stricter price cap regime, if the indexing system fails to capture the extent to which service-specific productivity increases exceed cap indices, an ILEC could recoup supracompetitive prices over time simply by keeping its reduced nominal price in place.[11]

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[11] Stated differently, recoupment occurs following destruction of a competitor when a successful predator collects a price which exceeds cost. Many times this would be accomplished through an increase in the nominal price. However, when productivity gains exceed price inflation, which is the typical case in the telecommunications industry, it can also occur by the ILEC simply leaving the nominal price in place as the service-specific costs drop. It is this form of "stealth predation" that poses the greatest threat to competitive telecommunications providers.

2. The Threat of Predation Is Not Limited Bankrupting Existing Competitive Facilities.

The predation analysis employed by USTA and the ILECs focuses unduly on a rather narrow threat: the elimination of an existing competitor through below cost pricing, and subsequent recoupment through above cost prices. Modern economic analysis has gone beyond the traditional structural approach to predation, and the ensuing critique from the Chicago school which USTA and the ILECs rely upon. Game theory analysis has been used to point out how pricing flexibility could be used to signal or "discipline" potential competitors from attempting to enter a market with no competitors, and high entry barriers. See Game Theory and the Law, Baird, Gertner and Picker (1994), discussing the game theory approach to analysis of the circumstances under which "strategic commitment" could be used to preclude competitive entry (at 57-63).[12]

Perhaps even more significantly, USTA and the ILECs err greatly in limiting the recoupment aspect of their predatory pricing analysis to just the profits immediately at stake in the access scenario. In reality, the access market is the entryway for competition in local telecommunications, where the ILECs have even greater profits at risk. If a successful predation strategy prevents or delays the erosion of an ILEC's local services

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[12] See also Holt and Scheffman, "Strategic Business Behavior and Antitrust" in Economics and Antitrust Policy, Larner and Meehan, editors (1989), discussing credible strategies for deterring competitive entry (at 53-61).

profits by deterring or delaying competitive access entry, it could prove immensely attractive economically even if no supracompetitive profits are earned in the access market alone.

3. Contrary to Second Further NPRM, "Inefficient" Competitive Entry Does Not Harm Consumers.

The Second Further NPRM also proposes to benefit consumers "indirectly by encouraging only efficient entry" (id. at ¶ 6. ALTS demonstrated in its initial comments that all competitive facilities are of immediate benefit to consumers, regardless of whether they ever prove profitable for their investors (at 10-12). To state the matter bluntly, it might hurt a K-Mart to have a WalMart move in across the street, but all their customers benefit regardless of how much money either store ends up losing.

One might expect that so basic an economic truth would go unquestioned. Not so. Haring and Rohlfs, on behalf of BellSouth, insist that ALTS' argument is "plainly false" (at 1). According to Haring and Rohlfs (id.):

> "Consider that competition which undermined an average rate scheme would raise prices for some consumers and lower prices for other consumers. The relevant question is whether competition can be expected to produce a more efficient allocation of resources and greater economic welfare in the aggregate."

Haring and Rohlfs thus are arguing that: (1) current lower SBI bands result in "inefficient" investment that deaverages the existing "average rate scheme"; (2) the resulting deaveraging distorts allocative efficiency, thereby reducing "aggregate" economic welfare by some amount; (3) consumers are injured by some

portion of that decrease; and (4) since the benefit which consumers receive from the competition created by the so-called "inefficient" investment is assertedly less than injury they incur from the decrease in allocative efficiency, elimination of lower SBI bands benefits consumers. Each step in this chain is essential to the Haring and Rohlfs "rebuttal," but they fail to offer support for any of these conclusions.

Competitive Planners Do Not Make Inefficient Investments

ALTS demonstrated in its Initial Comments that the initial assumption of Haring and Rohlfs' argument -- the notion that competitive planners assume regulated rates will continue uninterrupted when making their investment decisions -- is totally unfounded. Several commentors in addition to Haring and Rohlfs, including AT&T, MCI and Sprint, make the same mistake in their initial comments, so ALTS has appended a joint statement which explains that the competitive industry indeed understands the transient nature of regulated ILEC access rates, and fully incorporates this fact into its investment decisions.[13]

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[13] The awareness of the competitive industry concerning the ILECs' freedom to lower access rates is also reflected in their public financial filings. See, e.g., IntelCom Group Inc. Form 10-K filed December 18, 1995, at p. 11:

> "The FCC ... granted the RBOCs flexibility in pricing their interstate special and switched access services on a central office by central office basis. This increased pricing flexibility for the RBOCs may adversely affect the Company's ability to compete for certain services. If the RBOCs continue to lower rates, there would be downward pressure on certain special access switched access rates charged by CAPs..."

No Party Has Attempted to Show that Existing SBI Bands Produce Allocative Inefficiency

As for the second element of Haring and Rohlfs' argument -- the asserted allocative inefficiency and related decrease in aggregated welfare -- Haring and Rohlfs never quantify the amount of aggregate economic welfare they claim is produced by "inefficient" competitive entry. Instead, they speak only of "a presumption of increase" (at 1).

But Haring and Rohlfs' "presumption" is not necessarily shared by other expert witnesses retained by the ILECs. To their credit, Schmalensee and Taylor, speaking on behalf of USTA, explain that (Initial Statement at p.8, n. 16):

> "...of course, this allocative efficiency loss would be measured relative to the (unattainable) first-best standard of efficiency where price is set at marginal cost and the total cost of the firm is just recovered. This standard is of little use in measuring welfare losses in telecommunications where economies of scale keep marginal costs below average costs at current levels of output."

In short, Haring and Rohlfs are required to quantify the welfare loss in order to make their argument, but USTA's experts admit that such quantification poses immense methodological problems.

There is No Showing that Any Increase in Allocative Efficiency Would Flow to Consumers in Sufficient Amounts to Offset the Clear Benefits Consumers Enjoy from "Inefficient" Competition

Haring and Rohlfs also do not attempt to quantify the extent to which their assumed and unquantified welfare loss from "inefficient" investment would actually flow to telecommunications

consumers. There is no basis for assuming that all, or even a major portion of this amount would go to consumers. Consequently, there is no basis for Haring and Rohlfs' conclusion that such an amount would completely offset the obvious gain enjoyed by consumers from the entry of "inefficient" competition.[14]

IV. SPECIFIC ISSUES RAISED IN THE INITIAL COMMENTS.

ALTS' basic position -- that the Commission should not take any price cap action, with the minor exception of creating an operator services basket noted below, until it links all ILEC regulatory changes with entry barrier removal at both the state and Federal level -- disposes of almost all the specific issues raised by the Second Further NPRM. For the sake of clarity, however, ALTS addresses some of the specific questions below.

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[14] A cruder attack on ALTS' argument is also made by US WEST, which accuses ALTS of "chutzpah" in pointing out the simple fact that consumers -- as opposed to investors -- benefit from all kinds of entry (Reply Comments of US West filed January 11, 1996, at 3). According to US WEST, consumers are harmed by the reduced ILEC margins from "inefficient" entry because (id.): "...these dollars now also flow into the pockets of providers who leverage the subsidy-created rate disparities."

But the fact that some money which formerly flowed to an ILEC would go to an assertedly "inefficient" competitive facility would have no effect whatever on consumer welfare, which is the rationale offered in the Second Further NPRM. Introduction of "inefficient" entry could only benefit consumers, no matter what damage it inflicts on ILEC investors, unless it reached the point that necessary subsidy flows could not be sustained. And not even US WEST has the "chutzpah" to make that argument here.

A. Issues 1 and 2a: Price Cap Regulation of New Services and APPs

There is no reason whatever why there should be changes in the current price cap standards for either new services or Alternative Pricing Plans ("APPs"). AT&T correctly notes in its initial comments that the current cost showing includes a requirement that the ILEC justify its overhead loadings, which is an important factor in assessing the reasonableness of the ILEC pricing strategy (AT&T Comments at 22-26). Shifting to a direct cost standard would only resolve the issue of whether a particular service is compensatory; it offers no insight at all as to whether ILEC overheads are being recovered elsewhere improperly. Time Warner offers much the same insight concerning new services (at 10): "The relaxation of the regulatory requirements relating to new services is premature since the LECs retain their tremendous economies of scale and scope, and continue to control a remarkably high percentage of the market."

Time Warner goes on to point out the danger that ILECs would "label unbundled pieces of pre-existing services as new services. By utilizing pricing flexibility for new services, a LEC could quickly establish uneconomic rates for the unbundled pieces of various 'old' services that emerging competitors must purchase from the LEC. As a consequence, granting LECs pricing flexibility for such 'new' unbundled pieces of their existing services would grant them significant leverage and the direct ability to impair the economic viability of emerging competitors" (id. at 11). Time

Warner is entirely correct, particular as to its concern about allowing "close substitutes" for existing services to be automatically eligible for Track 2 reduced regulatory scrutiny (id.): "It is in these areas that the LECs retain the greatest market power and thus the ability to unfairly compete with the emerging competitors' service offerings."

ALTS also agrees that APPs should not be excluded from the definition of new services under price cap regulation. Precisely the same policy issues of reasonableness and unjust discrimination exist for APPs as for new services, so there is no sound basis for treating them differently. See AT&T Comments at 27-30; Time Warner Comments at 14.

B. Issues 2, 5a, and 20 - There Is No Current Need to Increase Downward Pricing Flexibility.

The Second Further NPRM proposes eliminating current price cap rules concerning downward pricing flexibility (at ¶ 81):

> "This conclusion was based in part on the growth in competition that the industry has experienced since the adoption of expanded interconnection for special access switched transport and in part on the substantial benefits that consumers would realize from lower prices. We noted that the Commission has other mechanisms at its disposal to inhibit predatory pricing, such as the continuing requirement that below-band rate reductions be accompanied by cost support, and the formal complaint process established by Section 208 of the Communications Act. Finally, we note that permitting LECs greater downward flexibility removes incentives for inefficient entry."

ALTS has already addressed the economic fallacy of "inefficient entry" in its initial comments and in the joint

statement attached to these reply comments. The supposed "growth in competition since the adoption of expanded interconnection" is also rebutted in these reply comments, infra at pp. 7-12. As for the current vitality of the complaint process, it suffices to point out that almost every major successful legal action concerning predatory behavior in the telecommunications industry in the last three decades was vindicated in the antitrust courts, not the Section 208 complaint process.

But one particular aspect of the ILECs' support of the Second Further NPRM's analysis of downward pricing flexibility does deserve a reply here. The ILECs contend that the existing lower Service Band Indices somehow deny lower prices to consumers. See, e.g., Bell Atlantic Comments at 22: "... downward pricing limits put a real constraint on a LEC's ability to lower prices;" USTA Comments at 30: "Restrictions on access pricing flexibility only serve to impede customer benefits because they prevent customers from taking full advantage of competition to realize reduced prices;" SWB Comments at 33: "In today's dynamically changing telecommunications market, the LECs should be allowed to engage in legitimate competitive pricing responses without being subjected to the cries of 'predatory pricing' by their competitors whenever a LEC engages in legitimate downward price competition;" BellSouth Comments at 26: "Such action will increase LEC pricing flexibility and allow price cap LECs to move prices closer to economic cost."

These claims that current downward pricing is somehow barred

by the lower SBIs simply disregard the plain facts of ILEC price cap regulation. The lower SBIs do not prohibit lower prices, they only trigger different procedures and substantive standards for proposed reductions. Indeed, the Commission labored long and hard in its LEC Price Cap Order, 5 FCC Rcd 6786 (1990), to carefully grant the ILECs the ability to lower prices below SBIs out of precisely the same jaundiced view of "predatory pricing" displayed in the Second Further NPRM (LEC Price Cap Order at ¶ 309): "We believe that rate reductions are generally beneficial to consumers and, more often than not, are undertaken for competitive reasons. Predatory pricing, though often alleged, is fairly uncommon, and proven cases are rare... [W]e seek a standard which requires suspension only of those rates which are so low that they can be presumed to be anticompetitive;" emphasis supplied. The Commission directed all ILECS seeking to file below-band rate reductions to file on 45 days notice with a "average variable cost standard to determine whether a below-band reduction should be suspended pending investigation" (id. at ¶ 311).

The LEC Price Cap Order utterly destroys the rationale employed by the Second Further NPRM for the removal of lower SBIs. The Commission was just as incredulous in the LEC Price Cap Order concerning predatory pricing, yet it concluded that it should adopt a suspension standard which affected "only those rates which are so low that they can be presumed to be anticompetitive." It is thus manifest that current ILEC price cap regulation was founded on the same view taken by the current Second Further NPRM,

and that it poses no meaningful impediment to the filing and effectiveness of lawful below-band rate reductions.

The ILEC initial comments amply demonstrate that current price cap regulation does not burden lawful below-band reductions, because none of the ILECs point to specific reductions that were prevented or deterred by the 45 day notice and cost support requirements. In short, in order to spare the ILECs the modest burden of below-band filings -- a burden which no ILEC shows has actually impeded any specific price reduction -- the Second Further NPRM would force competitors to rely on the Section 208 complaint process for protection against anticompetitive pricing. Obviously, there is no basis in logic or policy for the Second Further NPRM's radical departure from the LEC Price Cap Order as to how the respective burdens should be distributed concerning below-band price reductions.

C. Issue 3 - The ICB Rules Should Not Be Changed.

One aspect of the Second Further NPRM that deserves support is its proposal to retain the existing ICB policy recently restated by the Common Carrier Bureau (at ¶ 62; see also Public Notice released September 27, 1995). The initial comments of AT&T recognize that ICBs should be remain narrowly focused and regulated in noncompetitive markets because (at 31-32): "It affords LECs the flexibility to respond to unique customer needs that, at least initially, cannot be based on averaged rates, but [also] recognizes the anticompetitive potential of ICB pricing."

See also Time Warner initial comments at 17: "To ensure that LECs are in full compliance with this requirement, they should be required to file all ICB rates in a manner that sets forth the exact parameters of the service being provided under the rate."

D. Issues 8 and 9 - Operator Services Should Be Placed in a New Service Basket.

ALTS agrees with the commentors which have pointed out that operator services represent a "distinct type of service" (Time Warner Comments at 25), and should be placed into its own traffic sensitive price cap basket. As AT&T points out, the current price cap treatment: "provides the LECs an unwarranted ability to raise rates for these operator services relative to their other traffic sensitive or interexchange rates" (AT&T Comments at 53).

CONCLUSION

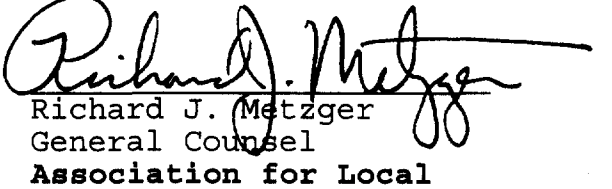
The initial comments thus reveal that the basic approach of the Second Further NPRM -- the essential abandonment of ILEC price cap regulation, even in the undisputed absence of competition -- is bad policy, as well as inconsistent with the Commission's recent ILEC price cap decisions. Instead, the Commission should seize the opportunity presented in the comments of NYNEX, the competitive industry, the long distance industry, and other parties, to advance competition to the point where ILEC price cap regulation would truly become unnecessary.

Accordingly, the Commission should:

- Decide to link all substantial regulatory changes (including access reforms) to the LECs' progress on removing barriers to competition; and,

- Solicit comments concerning the specific factors that should be considered in various "checklists" pertaining to price cap reform, access charge changes, universal service reform, etc., much like the "interLATA checklist" contained in the recently enacted Federal legislation. Once the basic outlines of each "checklist" has been sketched, its particulars could then be determined in specific proceedings.

Respectfully submitted:

By: 

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February 6, 1996

JOINT STATEMENT CONCERNING COMPETITIVE INVESTMENT PLANNING AND THE LEVEL OF REGULATED ILEC ACCESS RATES

This joint statement is submitted on behalf of various members of ALTS, a trade association of competitive telecommunications providers. The purpose of this affidavit is to correct a mistaken belief, reflected in the opening comments of several parties and in the Second Further NPRM, that the current price cap limitations on access rate reductions by the ILECS somehow encourages "inefficient" investment by competitors. Presumably this would occur because competitors would make investments assuming that regulation will always keep ILEC access rates above costs.

This belief about competitive behavior is entirely incorrect. First, competitive companies are well aware that the LEC Price Cap order permits the ILECs to price down to average variable costs on 45 days notice without suspension (LEC Price Cap Order at ¶ 311), and we also know that the Commission has provided the ILECs with term and volume flexibility, zone density adjustments, and increased lower Service Band Indices. Furthermore, the Commission has clearly stated its intention to move ILEC access rates to costs as quickly as possible (LEC Price Cap Order at ¶ 198). Consequently, competitive investment decision-makers definitely do not assume that ILEC rates will remain at current regulated levels when deciding whether to make investments. Accordingly, there are no "incorrect signals" or "distorted behaviors" concerning competitive investment that would support or require the abandonment of existing price cap rules on ILEC rate reductions.

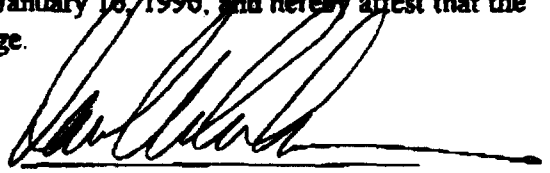
VERIFICATION

I, John C. Shapleigh, have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.

John C. Shapleigh

VERIFICATION

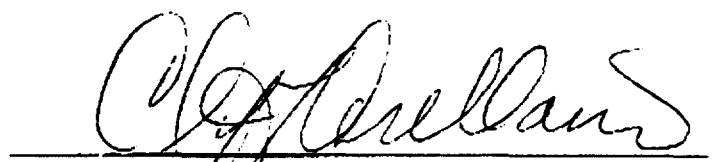
I, DAVID W. ACKERMAN have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.



DATED: JANUARY 18, 1996

VERIFICATION

I, Cliff Arellano, have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.



Vice President Diversified Communications, Inc.

VERIFICATION

I, Janis Stahlhut , have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.

Janis A. Stahlhut
Vice President, Regulatory Affairs
Time Warner Communications

VERIFICATION

I, Robert W. McCausland, have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.

Robert W. McCausland

MFS Communications Co., Inc.

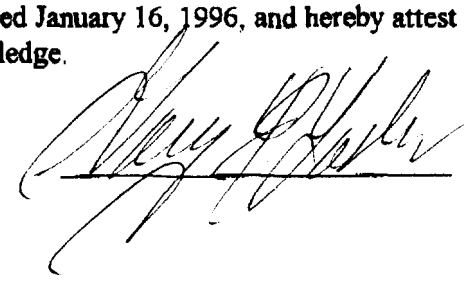
VERIFICATION

I, Barbara Stamos, have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.

January 16, 1996

VERIFICATION

I, Gary Lasher, have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.



VERIFICATION

I, W. Theodore Pierson, Jr., have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.

W. Theodore Pierson, Jr.

Advanced Radio Technology Ltd.

VERIFICATION

I, _____, have read the foregoing Joint Statement appended to the Reply Comments of ALTS in CC Docket No. 94-1, filed January 16, 1996, and hereby attest that the same is correct and true to the best of my knowledge.

KMC SouthEast Corp.